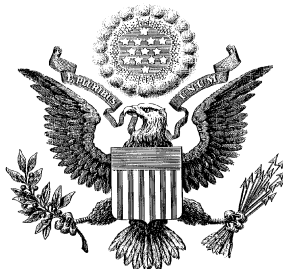


# THE TAXATION OF MUTUAL FUND INVESTORS: PERFORMANCE, SAVING AND INVESTMENT



**Chairman Jim Saxton (R-NJ)**  
**Joint Economic Committee**  
**United States Congress**  
**April 2001**

## **Abstract**

In order to increase personal saving and investment and to promote tax neutrality among various investment vehicles, the tax treatment of capital gains unrealized by mutual fund shareholders should be modified. The current policy of taxing mutual fund capital gain distributions unfairly discriminates against taxpayers seeking the investment benefits of diversification through mutual funds instead of through direct ownership of stocks. Therefore, the practice of taxing forced distributions of capital gains to mutual fund shareholders should be changed to allow for a deferral of taxation on reinvested capital gain distributions. Until shareholders realize a capital gain through the sale of an asset, no tax liability should incur. Since mutual funds are a popular vehicle for saving and investment of middle-income households, this tax reform would greatly increase the incentives for these people to invest and save for their future by increasing their after-tax rate of return.

A tax deferral on mutual fund capital gain distributions as proposed in H.R. 168, sponsored by Rep. Jim Saxton (R-NJ), could increase the *after-tax return* by almost 15 percent over a 30-year period for many mutual fund shareholders. For a hypothetical taxpayer with an initial \$10,000 investment in a mutual fund that returns 10 percent a year, the deferral on capital gain distributions as proposed in H.R. 168 would amount to \$15,055 over a 30-year period *after taxes*. This amounts to approximately 150 percent of the original \$10,000 investment.

A change in the tax treatment of mutual funds would have a beneficial impact on all owners of mutual funds, but the benefits would primarily help those making less than \$100,000 a year -- 81% of households owning mutual funds, with 39% of households owning mutual funds earning less than \$50,000 a year.

A deferral mechanism, as proposed under H.R. 168, is relatively simple and would not result in a significant paperwork burden for mutual funds or their shareholders.

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# THE TAXATION OF MUTUAL FUND INVESTORS: PERFORMANCE, SAVING AND INVESTMENT

## EXECUTIVE SUMMARY

This study examines the tax treatment of unrealized capital gains as they relate to forced distributions associated with regulated investment companies (such as mutual funds). Regulated investment companies pool investment money from numerous shareholders and invest in a diversified portfolio of securities to minimize risk and maximize returns. Regulated investment companies, such as mutual funds, have become an increasingly important vehicle for middle-income households to invest in the stock market and save for the future.

Under current law, shareholders pay taxes on dividends distributed by mutual funds generated by the companies in which the mutual funds own stocks or bonds. Shareholders also pay taxes on the appreciation of their mutual fund shares when they sell their shares for more than the original purchase price. The selling of mutual fund shares creates a capital gain or, if the shares are sold for less than the original purchase price, a capital loss. In addition, unfortunately, the current tax laws can force shareholders of mutual funds to pay capital gain taxes on their mutual funds even when shareholders choose not to sell shares. This policy of taxing forced distributions of capital gains to mutual fund shareholders unfairly discriminates against taxpayers seeking the investment benefits of diversification through mutual funds instead of through direct ownership of stocks.

Specifically, this report finds:

- In order to increase saving and investment by individuals and to promote tax neutrality among various investment vehicles, the tax treatment of unrealized individual capital gains should be modified to allow for a deferral on taxation of reinvested capital gain distributions.
- With respect to regulated investment companies, such as mutual funds, the realization point that triggers a capital gains tax liability should be moved from the corporate level down exclusively to the individual shareholder level.
- Since mutual funds are a popular vehicle for saving and investment of low- and middle-income households, this tax reform would greatly increase the incentives for these people to invest and save for their future by increasing their after-tax rate of return.
- The current tax treatment of mutual funds causes the average mutual fund investor between 15 percent and 20 percent a year in lost return.
- A tax deferral on mutual fund capital gain distributions as proposed in H.R. 168, sponsored by Rep. Jim Saxton (R-NJ), could increase the *after-tax return* by almost 15 percent over a 30-year period for many mutual fund shareholders.
- For a hypothetical taxpayer with an initial \$10,000 investment in a mutual fund that returns 10 percent a year, the deferral on capital gain distributions as proposed in H.R. 168 would amount to \$15,055 over a 30-year period *after taxes*. This amounts to approximately 150 percent of the original \$10,000 investment.

- A change in the tax treatment of mutual funds would have a beneficial impact on all owners of mutual funds, but the benefits would primarily accrue to those earning less than \$100,000 a year.
- A deferral of capital gain distributions would be a relatively simple record-keeping process for mutual funds and their shareholders (see Appendix).

# THE TAXATION OF MUTUAL FUND INVESTORS: PERFORMANCE, SAVING AND INVESTMENT

Taxes are the largest cost of mutual fund investment for most investors. Based on calculations from Morningstar, the average domestic equity fund returned about 13.5 percent annually on a pretax basis over the last 10 years. However, these funds returned about 11 percent on an after-tax basis, a difference of 2.5 percentage points per year.

Joel M. Dickson, The Vanguard Group<sup>1</sup>

Taxes can be the most significant cost of investing in a mutual fund.

Paul Royce, Director of Investment Management Division,  
U.S. Securities and Exchange Commission<sup>2</sup>

## I. INTRODUCTION

Mutual funds have become an important vehicle for low- and middle-income households to invest in the stock market and save for the future. Mutual funds pool investment money from numerous shareholders and invest in a diversified portfolio of securities to minimize risk and maximize returns. Over the past two decades, the number of families investing in mutual funds has increased 1,000 percent, from 4.6 million households investing in mutual funds in 1980, to a high of 50.6 million in 2000. For many families, mutual funds are a primary saving vehicle for retirement. However, mutual funds have one major drawback: the annual taxation of capital gains distributed by the mutual fund to its shareholders.

In a number of respects, the current tax system is counterproductive and biased against saving and investment. The tax system imposes large losses on the economy that reduce the economic welfare of households. The current levels of taxation can impose relatively high output and welfare costs on the economy. While the range of economic losses imposed by the current level of taxation is rather broad, a conservative estimate is that these excess marginal burdens range from 25 to 40 cents of the last dollars raised in

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<sup>1</sup> Testimony of Joel M. Dickson before the Subcommittee on Finance and Hazardous Materials of the Committee on Commerce, House of Representatives, U.S. Congress, October 29, 1999.

<sup>2</sup> U.S. Securities and Exchange Commission, Press Release, January 19, 2001, Available on-line at: <http://www.sec.gov/news/mfaffert.htm>

federal revenue; other estimates range much higher.<sup>3</sup> The tax treatment of mutual fund investors can be even more punitive.

Mutual fund investors fall into two basic categories: those who pay taxes annually on the distributions of fund dividends and capital gains, and those that hold their shares in qualified retirement plans (such as IRAs and 401(k)s). Assets held in qualified retirement accounts offer tax-deferred benefits on reinvested dividends and capital gain distributions and asset accumulation. But for shareholders holding mutual fund shares outside of qualified retirement accounts, the annual tax bite levied on their annual distributions can significantly reduce fund performance.

According to a recent study by KPMG Peat Marwick LLP, taxes due on the annual distributions made by mutual funds can decrease the performance of a mutual fund by up to 61 percent, or 7.7 percent percentage points a year.<sup>4</sup> The median loss due to taxes was 16.5 percent or 2.5 percentage points per year.<sup>5</sup> Over a ten-year period, on a \$10,000 initial investment, a 2.5 percentage point reduction in the performance on a mutual fund earning an annual pre-tax return of 10 percent would amount to a loss of over \$5,000. The loss would be almost \$25,000 over twenty years and \$87,000 over 30 years.<sup>6</sup>

This paper will address the tax treatment of mutual funds and implications for performance, saving and investment to the taxable mutual fund investor. Section II of this paper will address the circumstances that lead mutual fund investors to face tax liabilities on their mutual fund investments, even if investors choose not to sell any shares. Section III will address how the current tax treatment of mutual fund investors unfairly and punitively affect performance, saving and investment. Section IV of this study will then highlight some demographic statistics to illustrate the importance of mutual funds as an investment vehicle for millions of American families. Section V addresses policy considerations to restore the fair tax treatment of mutual fund investors.

Section V also examines a proposed remedy of this inequitable tax treatment, H.R. 168, introduced by Representative Jim Saxton and other members of Congress. The bill allows for a deferral of capital gain distributions up to \$6,000 for married couples filing jointly and \$3,000 for all other tax filers. Mutual fund companies would still make distributions, as required under current law. However, under H.R. 168, reinvested capital gain distributions would be deferred from taxation and given a zero basis by the fund. As this study later addresses, the deferral of capital gain distributions as proposed in H.R.

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<sup>3</sup> For more information, see United States Congress, Joint Economic Committee, *Tax Reduction and the Economy*. April 1999.

<sup>4</sup> KPMG Peat Marwick LLP, *Tax-Managed Mutual Funds and the Taxable Investor - 2000 Edition*, pages 18 and 19.

<sup>5</sup> *Ibid.*

<sup>6</sup> Amounts are calculated on a pre-liquidation basis.

168 could result in mutual fund investors achieving an after-tax return that is 15 percent greater than would result under current law.

The Appendix details the process under which taxpayers could elect for a deferral of capital gains distributions. Sample tax schedules are provided to illustrate that a deferral mechanism is relatively simple and would not result in a significant paperwork burden for mutual funds or their shareholders.

## II. TAXING MUTUAL FUND INVESTORS

Taxation of capital gains has been part of the U.S. tax system since the ratification of the 16<sup>th</sup> Amendment to the Constitution in 1913, which allowed for the taxation of individual income. Since that time, debate has engulfed various issues concerning if, how, and when capital gains should be taxed. One such debate has focused on the realization of capital gains.<sup>7</sup>

Realization of capital gains is the point in time at which ownership rights to capital assets are exchanged for money. Although many economists argue that capital gains should not be taxed at all, some economists argue a completely opposite position and suggest that capital gain taxes should be levied not only on realized capital gains, but on *unrealized* capital gains as well. Unrealized capital gains are the increases in the value of capital assets, for example stock prices, that are not sold for cash but are retained.

For example, if the stock price of Company XYZ was \$100 on January 1 and ended the year at \$150, shareholders of Company XYZ would have an unrealized gain of \$50. The capital gain (\$50) is unrealized if the shares are not redeemed for cash, but are instead retained for the future.

The primary problem with the taxation of unrealized capital gains is that it would force taxpayers to either sell capital assets or channel money from some other potentially productive source in order to pay the tax bill. This would not only be unfair, but it would also be inefficient as resources would have to be allocated away from higher valued uses in order to pay a tax bill. Fortunately, the current tax system *generally* doesn't impose such an onerous tax on investors by taxing their unrealized capital gains. However, when a taxpayer invests in a mutual fund, the problem is in how "*realization*" is defined. For mutual fund owners outside of individual retirement and similar accounts, capital gains unrealized by the taxpayer are subject to tax.

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<sup>7</sup> For information relating to the historical treatment surrounding the current rationale for taxing mutual fund capital gain distributions, see, United States Congress, Joint Economic Committee, *Encouraging Personal Saving and Investment: Changing the Tax Treatment of Unrealized Capital Gains*, June 2000. Available online at: <http://www.house.gov/jec/tax/mutual/mutual.pdf>

Realization, for purposes of taxing capital gains, is considered to be the point in time at which ownership rights to capital assets are exchanged for money. This seems straightforward in the following example: An individual owns 100 shares of stock in Company XYZ, which were purchased for \$100 (for a total cost of \$10,000). The individual later sells all 100 shares on the open market for \$150 each, or \$15,000. The individual has exchanged the shares for money. This creates a realized capital gain of \$5,000 and a tax liability to the investor on that gain.

However, the concept of realization can be confusing for mutual fund shareholders. Mutual fund shareholders pay taxes on dividends earned and distributed by mutual funds from their earnings in companies in which the mutual fund owns stocks or bonds. Additionally, shareholders pay taxes on the appreciation of their mutual fund shares when they sell their shares for more than the original purchase price. The selling of mutual fund shares creates a capital gain, or if the shares are sold for less than the original purchase price, a capital loss. Unfortunately, the current tax law treatment of capital gain realizations also can force shareholders of mutual funds to pay capital gain taxes on their mutual fund holdings even when shareholders choose not to sell shares.

This situation occurs in the following example: An individual owns 1,000 shares in Mutual Fund ABC, which were purchased for \$10 per share (for a total cost of \$10,000). The shares of the mutual fund represent ownership, or various rights to capital assets, in the mutual fund. In the course of the mutual fund's normal buying and selling of securities, any assets that are sold by the mutual fund at a price in excess of that at which they were purchased creates a realized capital gain and a tax liability. If Mutual Fund ABC realizes a capital gain of \$1 per share, the individual investors are responsible for the tax liability even if they themselves haven't "realized" or exchanged their shares for money. Even though the gains are reinvested, this is considered to be a realized gain *to the mutual fund company*. The tax liability is passed through to the individual shareholders even though this is an *unrealized* gain to the shareholders of the mutual fund.

In the previous example, the mutual fund shareholder would be responsible for a capital gain tax on \$1,000, or \$1 for each of the 1,000 shares owned of Mutual Fund ABC. This is because the mutual fund company is deemed by the tax law to have "realized" a capital gain and, hence, tax is due. This is the case even if individual shareholders do not redeem any shares and the mutual fund reinvests the gain in other capital assets.

Although only a few corporate investment structures are required to pass through gains (and the tax liability) onto their shareholders, the most prevalent type of investment vehicles affected by this tax quirk falling under this definition of "realization" are mutual funds. Mutual funds pool investment money from numerous shareholders and invest in a diversified portfolio of securities to minimize risk and maximize returns. Increasingly, mutual funds have become an important vehicle for low- and middle-income households to invest in the stock market and save for the future.

Throughout the course of a mutual fund's normal operations, fund managers buy and sell securities attempting to maximize returns to shareholders. In order to eliminate corporate income tax liability on the gains earned from the sale of securities, mutual funds must distribute to their shareholders all of their ordinary income and net capital gain. The gains mutual funds distribute to individual shareholders are subject to capital gains taxation on the individual's federal and state tax returns. Any undistributed profits of the mutual fund are taxed at the corporate rate.

Even if individual shareholders do nothing more than buy and hold mutual fund shares, they could still be hit with potentially large tax liabilities due to the distribution of gains from their mutual funds. Shareholders are then either forced to sell assets to pay the tax liability, or must divert capital from other more productive uses in order to pay the tax. This is economically inefficient and creates an opportunity cost to the shareholder and can result in considerable economic losses due to compounding.

Although direct owners of stocks pay taxes on dividends received, they do not have to pay taxes on the appreciation of their securities until they sell their shares and actually realize a gain. For direct ownership of stocks, the realization point that triggers a tax liability is the selling of securities by the individual owner. In the case of mutual funds, one realization point that triggers a tax liability for shareholders is the selling of securities by the mutual fund, generating taxes on unrealized gains at the individual level. This treatment violates the economic principle of horizontal equity.

Direct owners of stocks are allowed to defer taxation on the appreciated value of their stock shares, while mutual fund shareholders may be forced to pay taxes yearly even if they don't sell (i.e., redeem) any of their mutual fund shares. The current tax treatment of mutual funds is an unfair economic disadvantage to low- and middle-income households, who invest in mutual funds because they usually cannot afford the relatively large amounts of capital necessary to build their own diversified portfolio of stocks. Additionally, the policy of taxing forced distributions of capital gains to mutual fund shareholders unfairly discriminates against taxpayers seeking the investment benefits of diversification through mutual funds instead of through direct ownership of stocks.

In order to treat mutual fund shareholders and direct stock owners more equally, and to further increase and encourage saving and investment, taxpayers investing in mutual funds outside of individual retirement accounts should be allowed a tax deferral on forced capital gain distributions. In essence, this would provide a rollover treatment of these unrealized capital gains.



Leonard Burman, an Urban Institute Senior Fellow and former U.S. Treasury Deputy Assistant Secretary for Tax Analysis under the Clinton Administration, states with respect to rollover of gains in general:

Advocates of this approach argue that the tax code should distinguish between sales of assets to finance consumption and sales in which the proceeds are reinvested. It might also be argued that this option is a natural extension of the realization principle of taxation: that is, tax is due only when the owner of an asset has exchanged it for cash.<sup>8</sup>

Furthermore, since mutual funds are a popular vehicle for saving and investment of low- and middle-income households, this tax reform would greatly increase the incentives for these people to invest and save for their future by increasing their rate of return. As Burman also states:

Deferral reduces the effective tax rate on assets that pay returns in the form of capital gains much more than on income-producing assets. Because the tax can be deferred, the money that would have gone to pay taxes can continue to earn returns until the tax is paid.<sup>9</sup>

### III. ECONOMIC CONSIDERATIONS

American mutual fund shareholders are often unaware of the tax that they will owe on a fund's capital gain distributions before the distributions are received. The importance of forced distribution of capital gains by mutual funds is evidenced by the extensive media coverage advising shareholders of mutual funds about the economic consequences.

For example, last year *Business Week* ran a special report titled "Mutual Funds: What's Wrong," that highlighted some of the economic consequences of forced distributions. "The gains are triggered when managers take profits – a process over which the fund shareholder has no control. Over the past five years, taxes have effectively cost fund shareholders about 2.3 percentage points a year..."<sup>10</sup> A more recent study by KPMG finds that the effective cost of taxation actually has a median value of

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<sup>8</sup> Leonard Burman, *The Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed*, Washington, DC: Brookings Institution, 1999, page 136.

<sup>9</sup> *Ibid.*, page 48.

<sup>10</sup> Jeffrey Laderman and Amy Barrett, "Mutual Funds: What's Wrong," *Business Week*, January 24, 2000, page 72.

2.5 percentage points a year.<sup>11</sup> Another article states that "...it's common for a stock fund's after-tax return to be 15 percent to 20 percent less than its pretax return."<sup>12</sup>

For a shareholder portfolio that starts out with \$10,000 in the first year and returns 10 percent a year before liquidation, an annual 2.5 percentage point reduction in pre-liquidation return would amount to \$5,327 over 10 years, \$24,796 over 20 years and \$86,944 over 30 years. According to the Investment Company Institute, the median value of stock mutual funds held outside of employer-sponsored retirement plans in 1999 was \$26,000.<sup>13</sup> Assuming the same 10 percent rate of return, the same annual 2.5 percentage point reduction would amount to \$13,850 over 10 years, \$64,471 over 20 years and \$226,056 over 30 years!

Another article points out the confusion mutual fund investors face when they have to calculate their cost basis (the average cost they paid for their shares).<sup>14</sup> The average cost basis must include reinvested dividends and capital gains -- the same dividends and capital gains on which mutual fund owners have already paid taxes. Although many mutual fund companies now calculate the average cost basis for their shareholders, the failure of some taxpayers to account for reinvested dividends and capital gains could result in some taxpayers paying tax twice on the same reinvested dividends and capital gains.

As has been discussed, taxes on annual distributions can comprise the greatest cost to shareholders. When the market is growing, many shareholders may not notice the drag these taxes impose on fund performance. However, the drag is exacerbated when the market is in decline, as was the case for 2000.

The following three tables illustrate the significance of capital gain distributions on mutual fund performance. Table 1 displays performance and distribution results for the largest mutual funds of 2000; the second table provides information for the best one-year performers of 2000; the final table provides similar information for the worst one-year performers of 2000.

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<sup>11</sup> KPMG Peat Marwick LLP, *Tax-Managed Mutual Funds and the Taxable Investor - 2000 Edition*, pages 18 and 19.

<sup>12</sup> Leonard Wiener, "The Best-Laid Tax Plans Can Falter When Gains Soar," *U.S. News & World Report*, January 24, 2000, page 68.

<sup>13</sup> Investment Company Institute and the Securities Industry Association, "Equity Ownership in America," Washington, DC: Fall 1999, page 43.

<sup>14</sup> Kathy Jones, "Easy Pickin's," *Kiplinger's*, February 2000, pages 84-87.

**Table 1 - Largest Stock and Balanced Funds for 2000**

	Assets (\$mil)	NAV (\$) 12/31/2000	Performance for 2000 (%)	Capital Gain Distribution (\$)	Capital Gain Distribution (%)
Fidelity Magellan Fund	\$92,588.1	\$119.30	-9.29%	\$4.69	1.79%
Vanguard 500 Index;Inv	\$89,393.8	\$121.86	-9.06%	NA	NA
Investment Co Amer:A	\$54,352.0	\$30.72	3.84%	\$2.08	3.24%
Washington Mut Inv:A	\$45,418.5	\$28.61	9.06%	\$2.50	8.15%
Janus Fund	\$40,081.0	\$33.29	-14.91%	\$3.84	9.92%
Fidelity Gro & Inc	\$39,761.7	\$42.10	-1.98%	\$3.91	4.30%
Fidelity Contrafund	\$39,241.8	\$49.17	-6.82%	\$6.62	5.78%
Growth Fund of Amer:A	\$36,109.9	\$26.43	7.49%	\$4.10	13.20%
Janus Worldwide	\$33,953.0	\$56.86	-16.87%	\$6.17	9.48%
Amer Cent: AC Ultra;Inv	\$33,733.8	\$32.37	-19.91%	\$4.41	11.73%
EuroPacific Growth:A	\$31,243.2	\$31.57	-17.84%	\$3.74	10.03%
New Perspective Fund:A	\$30,625.6	\$24.11	-7.24%	\$3.10	11.39%
Fidelity Growth Company	\$29,145.3	\$71.43	-6.32%	\$7.50	4.68%
Fidelity Blue Chip Grow	\$26,720.7	\$51.53	-10.54%	\$2.52	2.18%
Vanguard Instl Indx;Ins	\$26,574.5	\$120.72	-8.95%	NA	NA
Janus Twenty	\$26,193.0	\$54.80	-32.42%	\$1.75	2.81%
Vanguard Windsor II	\$23,494.4	\$27.20	16.86%	\$1.24	4.59%
Vanguard Wellington Fund	\$22,524.4	\$28.21	10.40%	\$1.48	5.05%
Fidelity Equity-Inc	\$21,432.5	\$53.43	8.54%	\$3.32	6.08%
Putnam Voyager:A	\$21,328.0	\$23.30	-16.78%	\$2.60	9.78%
Vanguard PRIMECAP	\$21,034.4	\$60.38	4.47%	\$4.05	2.93%
Fidelity Puritan	\$20,720.6	\$18.83	7.77%	\$1.01	2.64%
Putnam Gro & Inc:A	\$19,511.0	\$19.53	7.94%	\$0.31	1.63%
Fundamental Invest:A	\$19,248.8	\$30.75	4.27%	\$2.36	3.67%
Income Fd of America:A	\$17,769.0	\$15.89	9.98%	\$0.48	3.05%
Fidelity Sprt US Eq Indx	\$17,600.4	\$46.81	-9.18%	NA	NA
Vanguard Health Care	\$17,507.9	\$132.74	60.54%	\$15.93	11.19%
Vanguard Tot Stk Idx;Inv	\$16,578.7	\$29.26	-10.57%	\$0.14	0.22%
Vanguard US Growth	\$16,549.9	\$27.65	-20.17%	\$7.45	20.33%
AXP: New Dimensions:A	\$15,825.5	\$28.21	-8.82%	\$3.46	11.40%
AIM Eq:Consteln:A	\$15,607.8	\$28.93	-10.37%	\$7.42	20.33%
Vanguard Windsor	\$15,404.9	\$15.29	15.89%	\$1.85	11.51%
Putnam New Oppty:A	\$15,044.4	\$58.62	-26.15%	\$9.46	14.75%
Fidelity Fund	\$14,905.9	\$32.76	-11.00%	\$5.20	6.83%
Fidelity Aggr Grow	\$14,638.4	\$36.17	-27.14%	\$7.58	7.65%
Fidelity Adv Gr Opp:T	\$13,847.9	\$34.15	-18.25%	\$4.02	4.76%
Janus Mercury	\$13,620.0	\$29.67	-22.75%	\$2.78	8.09%
Fidelity Equity-Inc II	\$13,408.9	\$23.86	7.46%	\$4.98	9.01%
Fidelity Asset Manager	\$12,782.1	\$16.82	2.38%	\$1.34	7.44%
AIM:Value:B	\$12,450.1	\$11.94	-15.65%	\$1.31	10.04%
Templeton Growth:A	\$12,193.4	\$18.39	1.74%	\$1.42	3.88%
Vanguard Growth Indx;Inv	\$11,960.3	\$30.57	-22.21%	NA	NA
Fidelity OTC	\$11,652.7	\$41.05	-26.81%	\$12.66	10.81%
MSDW Div Gro:B	\$11,623.4	\$53.83	5.33%	\$5.84	5.44%
Fidelity Dividend Growth	\$11,303.6	\$29.96	12.25%	\$2.40	3.81%

(1) Returns for periods ended December 31, 2000; Assets as of Nov. 30, 2000.

(2) Performance data are cumulative total returns, which include both share prices and reinvested dividends.

(3) N.A. = Not Applicable / Not Available.

(4) Note: For funds with multiple share classes, only the largest is shown.

(5) Source: Lipper Inc. Every attempt was made to verify the data, though data accuracy cannot be guaranteed.

(6) Capital gains distribution (%) estimated by: CGD/(Ex Date NAV+CGD) -- weighted averages were used for funds that had more than one distribution for the year.

As can be seen from Table 1, almost all of the funds paid out a capital gain distribution in 2000. Furthermore, 27 out of the total 45 largest stock and balanced funds listed in Table 1, or **60 percent**, posted a negative return for 2000. Of those 27 with negative returns, 23 funds, or **85 percent**, also had capital gain distributions. As a percent of Net Asset Value (NAV), the range of capital gain distributions ranged from less than 1 percent to a high of 20 percent of NAV.

**Table 2 - Best 1-Year Performers of 2000**

	Assets (\$mil)	NAV (\$) 12/31/2000	Performance for 2000 (%)	Capital Gain Distribution (\$)	Capital Gain Distribution (%)
Schroder Cap:MicroCp:Inv	\$82.7	\$28.4	147.70%	\$20.85	43.60%
Evergreen Hlth Care:B	\$28.5	\$15.71	117.57%	\$6.09	17.49%
Deutsche Euro Eq:Inst	\$46.0	\$28.96	96.70%	NA	NA
Nich-App Instl:Gl Hlth:I	\$152.4	\$29.71	96.33%	\$7.70	21.53%
Munder Fram:Hlthcare:B	\$222.8	\$28.50	85.17%	\$0.76	1.27%
American Eagle:Cap App	\$12.8	\$9.79	84.67%	\$8.79	46.99%
SS Research: Gl Res:A	\$54.8	\$21.01	84.14%	NA	NA
Dresdner RCM:Biotech:N	\$809.7	\$36.38	81.93%	\$0.04	0.11%
Eaton Vance Ww H&S:A	\$529.7	\$11.63	81.65%	\$0.51	2.13%
ICON:Energy	\$37.8	\$13.89	78.65%	\$1.12	7.85%
Prudential Sect:Hlth:B	\$222.7	\$16.61	74.11%	\$2.61	8.14%
Dresdner RCM:Gbl HC	\$220.5	\$24.60	73.37%	\$0.10	0.42%
Fidelity Sel Nat Gas	\$331.9	\$24.31	71.28%	\$0.30	0.77%
Franklin Str:Gl Hl: A	\$164.2	\$26.82	69.27%	\$1.50	5.53%
Fidelity Sel Medical	\$251.5	\$27.59	67.82%	NA	NA
Vertex Contr:A	\$27.3	\$34.31	67.19%	\$35.59	44.72%
Monterey:Murphy NW Bio	\$20.3	\$7.94	63.78%	\$4.73	36.70%
Vanguard Health Care	\$17,507.9	\$132.74	60.54%	\$15.93	6.51%
Scudder Health Care:S	\$229.4	\$23.34	59.79%	\$0.69	2.87%
Galaxy II:Utility Index	\$75.8	\$17.66	59.35%	\$1.57	8.50%
Boston Prtn:LS Eq:Inst	\$1.2	\$12.87	58.50%	NA	NA
INVESCO Energy:Inv	\$374.3	\$20.88	58.17%	\$1.43	7.86%
Kinetics: Medical	\$60.9	\$20.98	57.04%	NA	NA
MSDW Hlth Sci:B	\$670.1	\$19.91	57.02%	\$2.58	11.47%
Rushmore Amer Gas Index	\$291.2	\$20.67	55.86%	\$2.51	10.83%
CRM:Mid Cap Value:Inst	\$25.4	\$16.50	55.55%	\$0.57	3.60%
Franklin Str:Long-Sht:A	\$66.0	\$20.49	55.08%	\$0.93	4.43%
Orbitex:Health & Bio:B	\$113.5	\$20.77	55.01%	\$0.51	2.48%
CGM Tr:Focus Fund	\$54.0	\$15.80	53.93%	NA	NA
Lord Abbott MdCp Val:A	\$507.0	\$17.03	53.30%	\$2.44	8.00%
Fidelity Sel Insurance	\$173.7	\$51.75	53.27%	\$0.65	1.32%
T Rowe Price Hlth Scienc	\$863.0	\$21.70	52.19%	\$2.48	10.63%
AIM Inv:Gl Hlth Care:A	\$492.8	\$30.66	52.08%	\$3.24	10.34%
New Alternatives Fund	\$48.3	\$41.29	51.76%	\$2.12	4.88%
Fidelity Sel Med Equip	\$132.5	\$16.91	50.39%	\$2.31	7.14%
Fidelity Sel Enrgy Ser	\$623.7	\$37.45	50.34%	NA	NA
Fidelity Sel Home Fin	\$362.1	\$55.33	50.25%	\$0.07	0.13%
ICON:Financial	\$74.8	\$12.76	50.02%	\$1.29	9.61%
American Eagle:Twenty	\$8.7	\$9.36	49.66%	\$5.96	37.46%
SS Research:Health:A	\$2.6	\$3.63	48.24%	NA	NA
FBR:Financial Svcs:A	\$26.0	\$19.91	47.19%	NA	NA
First Amer:Hlth Sci:Y	\$18.2	\$11.85	47.09%	\$1.37	10.69%
Franklin Str:Biotech Dis	\$1,274.2	\$73.00	46.58%	\$0.19	0.26%
Fairholme:Fairholme Fund	\$13.9	\$14.68	46.54%	\$0.25	1.67%
Burman:Micro-Cap Growth	\$90.9	\$41.20	45.62%	\$2.69	6.53%
SG Cowen:Inc+Gro:A	\$34.7	\$14.37	45.53%	\$0.44	3.07%
Boston Prtn: SC VI2:Inst	\$1.9	\$12.24	44.59%	\$0.29	2.36%
Oppenheimer RI Asset:A	\$170.8	\$8.27	44.44%	\$0.06	0.70%
Mercury:HW MdCp Val:I	\$18.0	\$15.28	44.34%	\$0.36	2.51%
UAM Tr:Clipp Foc:Inst	\$176.6	\$15.53	44.29%	\$0.41	2.72%

- (1) Returns for periods ended December 31, 2000; Assets as of Nov. 30, 2000.  
(2) Performance data are cumulative total returns, which include both share prices and reinvested dividends.  
(3) N.A. = Not Applicable / Not Available  
(4) Note: For funds with multiple share classes, only the largest is shown.  
(5) Source: Lipper Inc. Every attempt was made to verify the data, though data accuracy cannot be guaranteed.  
(6) Capital gains distribution (%) estimated by: CGD/(Ex Date NAV+CGD) -- weighted averages were used for funds that had more than one distribution for the year.

A high capital gain distribution may trigger tax consequences that are costly but can be bearable in the context of strong performance, such as for those funds listed in Table 2. But for shareholders holding funds that performed poorly in 2000, a capital gain distribution will trigger taxes that greatly magnify and deepen the negative impact on personal saving and investment.

Table 3 - Worst 1-Year Performers of 2000

	Assets (\$mil)	NAV (\$) 12/31/2000	Performance for 2000 (%)	Capital Gain Distribution (\$)	Capital Gain Distribution (%)
Jacob Internet Fund	\$76.0	\$2.11	-79.11%	NA	NA
Potomac:Internet+:Inv	\$0.8	\$3.03	-77.34%	NA	NA
Apex Mid Cap Gro	\$0.6	\$1.35	-75.81%	\$0.51	27.42%
IGAM:Internet Index	\$1.2	\$3.99	-74.36%	\$0.46	10.26%
ProFunds:UltraOTC:Inv	\$495.9	\$22.82	-73.70%	\$3.54	13.44%
Warb Pincus JP SmCo:CM	\$136.4	\$2.23	-71.81%	\$9.44	50.68%
ING Funds:Internet:A	\$58.7	\$5.78	-69.16%	\$1.85	24.25%
Warb Pincus JP Gro: CM	\$139.1	\$6.96	-68.70%	\$5.65	19.90%
StockJungle:Pure Play	\$0.3	\$4.31	-66.62%	NA	NA
Amerindo:Technology:D	\$248.2	\$11.68	-64.79%	NA	NA
Ameritor:Industry	\$0.4	\$0.33	-63.33%	NA	NA
Kinetix:Internet Emerg	\$5.3	\$3.69	-63.10%	NA	NA
Fidelity Adv Korea:A	\$17.6	\$6.61	-58.79%	NA	NA
Investec:Internet.com	\$30.0	\$9.12	-58.57%	\$0.31	3.29%
Monterey:Murphy Tech	\$3.5	\$10.23	-58.55%	\$0.28	2.66%
Matthews Intl:A Tech	\$10.9	\$4.17	-57.04%	NA	NA
Monument Internet:A	\$57.2	\$7.11	-56.88%	NA	NA
WWW Internet Fund	\$46.9	\$15.39	-56.83%	\$2.95	16.09%
IPS Funds:New Frontier	\$11.1	\$17.49	-56.28%	NA	NA
Thurlow Growth	\$4.9	\$6.50	-56.02%	\$6.54	50.15%
Unified:Sel Internet	\$0.8	\$6.89	-55.62%	NA	NA
Firsthand E-Commerce	\$228.9	\$6.63	-55.08%	\$0.05	0.75%
Munder:NetNet:B	\$1,737.3	\$34.09	-54.57%	\$0.47	1.36%
AIM Japan Gro:A	\$71.9	\$8.88	-53.73%	NA	NA
Prasad:Growth Fund	\$0.9	\$4.92	-53.44%	\$4.47	47.61%
Matthews Intl:Korea	\$83.2	\$2.24	-52.84%	\$1.50	40.11%
Liberty:Nwp Jap Opp:B	\$18.6	\$11.87	-52.77%	NA	NA
Midas US and Overseas	\$4.3	\$4.52	-51.99%	\$0.65	5.47%
Frontier:Equity Fund	\$0.4	\$1.61	-51.51%	NA	NA
Kinetix: Internet Fund	\$491.4	\$24.12	-51.49%	NA	NA
Enterprise: Internet:B	\$107.5	\$15.36	-51.34%	\$0.10	0.65%
Putnam OTC Emerg Gro:A	\$3,266.7	\$13.92	-51.27%	\$4.59	24.80%
Federated Aggr Grow:A	\$140.8	\$14.25	-51.02%	\$0.04	0.28%
Fidelity Japan Sm Co	\$510.5	\$7.98	-50.23%	\$4.46	35.85%
H&Q:IPO & Emg Co:A	\$202.0	\$7.21	-49.13%	NA	NA
Pilgrim Adv:Asia-Pc:B	\$6.5	\$4.44	-48.11%	NA	NA
Potomac: OTC Plus:Inv	\$83.2	\$21.70	-47.80%	NA	NA
Van Eck:Asia Dynst:A	\$15.1	\$6.97	-47.56%	\$0.68	8.89%
Pilgrim Wrlwd Emerg:A	\$70.2	\$7.99	-47.09%	NA	NA
RS Inv:Internet Age	\$107.9	\$6.53	-46.39%	NA	NA
Kemper Asian Growth:A	\$8.5	\$4.86	-46.14%	NA	NA
Prudential Pac Gr:B	\$46.2	\$8.22	-45.85%	NA	NA
Janus Venture	\$1,458.0	\$49.94	-45.77%	\$16.38	24.70%
Investec:Asia Sm Cap	\$17.4	\$5.16	-45.74%	NA	NA
Kinetix:Internet Infra	\$11.1	\$5.43	-45.70%	NA	NA
Federated Comm Tech:B	\$313.7	\$10.14	-45.63%	NA	NA
First Amer:Tech:Y	\$229.1	\$21.21	-45.62%	\$7.62	26.43%
Millennium Growth	\$13.1	\$11.09	-45.28%	\$0.90	7.51%
ASAF:Jan Sm-Cap:B	\$125.0	\$13.50	-44.90%	NA	NA
Federated Asia Pac:A	\$19.5	\$8.58	-44.72%	NA	NA

(1) Returns for periods ended December 31, 2000; Assets as of Nov. 30, 2000.

(2) Performance data are cumulative total returns, which include both share prices and reinvested dividends.

(3) N.A. = Not Applicable / Not Available

(4) Note: For funds with multiple share classes, only the largest is shown.

(5) Source: Lipper Inc. Every attempt was made to verify the data, though data accuracy cannot be guaranteed.

(6) Capital gains distribution (%) estimated by: CGD/(Ex Date NAV+CGD) --

weighted averages were used for funds that had more than one distribution for the year.

In one of the more extreme cases, the ramifications can hardly be stated better than was done in an article on the online financial web site, *TheStreet.com*:

If you started last year with \$10,000 invested in the Warburg Pincus Japan Small Company fund and reinvested all distributions, your account was worth only [\$2,820] at year-end, a drop of 71.8%. Adding insult to injury, you would owe taxes on \$4,070 in income and capital gains.<sup>15</sup>

Based on the information in Table 3, the Warburg Pincus Japan Small Company fund capital gain distribution was \$9.44 per share. This fund did not pay out any dividend distributions for the year, only capital gain distributions. If the 20 percent tax rate is applied to the capital gain distributions, this taxpayer would be faced with a tax bill of approximately \$814 based solely on the reinvested distributions made by a fund that lost 71.8 percent for the year. If the return is calculated net of taxes, the initial \$10,000 investment is now only worth \$2,006 -- for an *economic loss* of roughly 80 percent.<sup>16</sup>

Though this is an extreme example, it serves to highlight the severe impact taxes resulting from annual distributions can have on the taxable mutual fund investor. The example further illustrates how taxing forced capital gain distributions can add tax insult to investment injury for the low- or middle-class investor who not only has to deal with the loss of equity but also has to pay the taxman, even if the investor didn't sell any shares in the fund.

Changing the tax treatment of mutual funds to allow the realization point that triggers a capital gains tax liability to be moved from the mutual fund level exclusively to the shareholder level would increase the rate of return to shareholders and relieve millions of shareholders of the burdensome necessity of accounting for reinvested capital gain distributions. A change in tax treatment would also relieve part of the potential burden on the average American family of being taxed twice on the same gains.

Allowing for a deferral of tax on capital gain distributions would have eased the tax burden faced by investors in the Warburg fund and many other funds that had capital gain distributions, regardless of whether the fund had a negative return for the year.

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<sup>15</sup> Mercer Bullard, "Industry Trying to Defang Law Disclosing the Tax Bite on Fund Returns," *TheStreet.com*, February 8, 2001, available online at: <http://www.thestreet.com/pf/funds/mercerbullard/1297839.html>

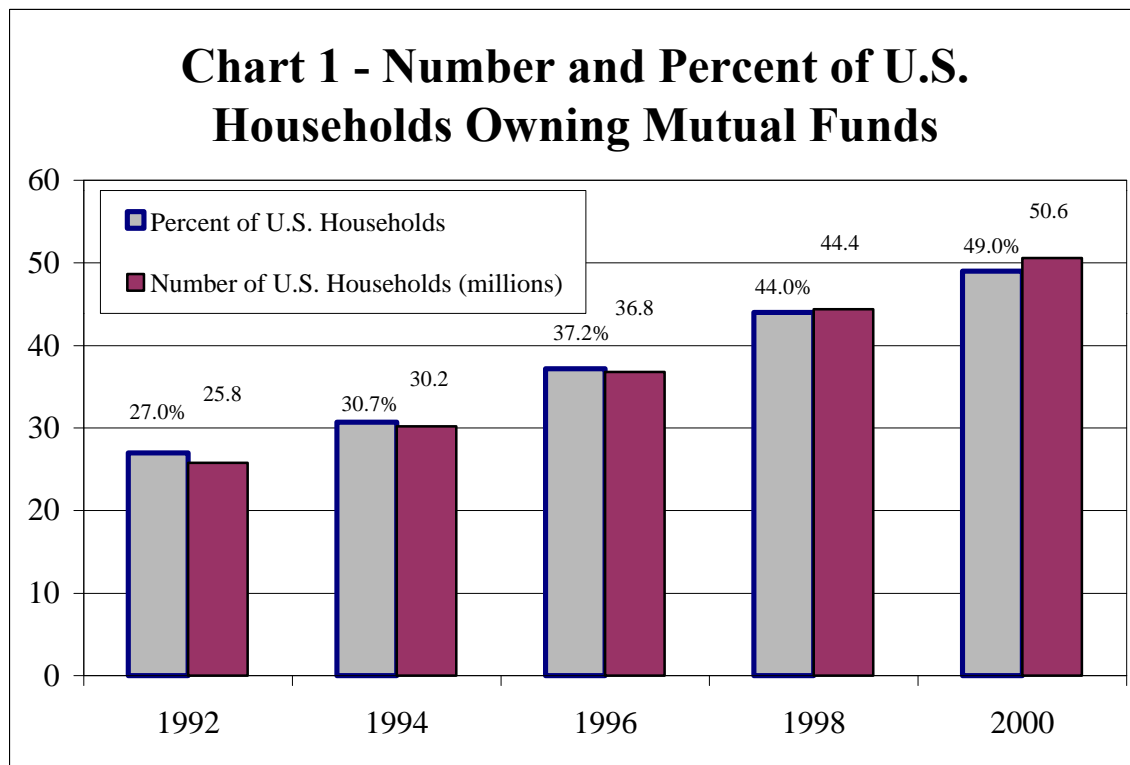
Note: Text has been changed to correctly reflect a loss of 71.8%, as reported by Lipper, Inc. Text originally listed end of year balance as \$2,420, which would actually be a loss of 75.8%. Performance is cumulative total return, which include both share price and reinvested dividends.

<sup>16</sup> Calculated on a pre-liquidation basis and does not include state tax liability.

## IV. DEMOGRAPHIC HIGHLIGHTS

Before examining in detail a policy proposal that addresses the unfair tax treatment of mutual fund shareholders, some demographic highlights are provided. A review of the data shows that many millions of Americans could benefit from a deferral of unrealized capital gains taxation associated with mutual funds.

Almost 88 million individuals, comprising over 50 million households (or 49.0% of all U.S. households), owned mutual funds as of June 2000.<sup>17</sup> Sixty-two percent of



Source: Investment Company Institute. August 2000.

fund-owning households have some assets in employer-sponsored retirement plans and 57 percent have Individual Retirement Accounts.<sup>18</sup> Mutual fund assets held outside of retirement accounts represented 64 percent, or approximately \$4.4 trillion of the total \$6.8 trillion in mutual fund assets at the end of 1999.<sup>19</sup> Based on IRS data, 16.1 million

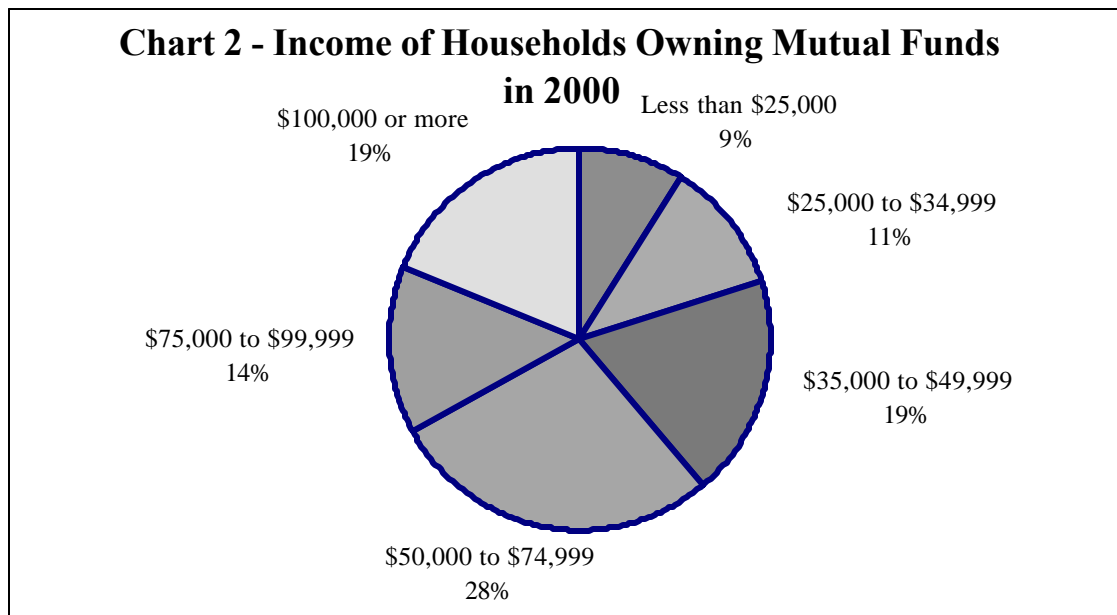
<sup>17</sup> Investment Company Institute, *Fundamentals: Investment Company Institute Research In Brief*, Vol. 9, No. 4. Washington, DC: August 2000.

<sup>18</sup> Investment Company Institute, *Mutual Fund Fact Book – 2000*, Washington, DC: 2000, page 44.

<sup>19</sup> *Ibid.*, pages 44 and 69.

tax returns were filed in 1998 that claimed taxable mutual fund capital gain distributions.<sup>20</sup> This represents approximately 25 million shareholders.

According to the Investment Company Institute (ICI), as of 2000, 81 percent of households that owned shares in mutual funds had an annual household income under \$100,000. Moreover, 39 percent of households that own mutual funds have an annual household income less than \$50,000.<sup>21</sup>



Source: Investment Company Institute. August 2000.

<sup>20</sup> Internal Revenue Service, *Statistics of Income Bulletin*, Washington, DC: Fall 2000.

<sup>21</sup> Investment Company Institute, *Fundamentals: Investment Company Institute Research In Brief*, Vol. 9, No. 4. Washington, DC: August 2000.



Furthermore, as Table 4 illustrates, a significant percentage of U.S. middle-class households own mutual funds. Forty-nine percent of households with income between \$35,000 and \$49,999 own mutual funds; 66 percent of households with incomes between \$50,000 and \$74,999; and 77 percent of households with income between \$75,000 and \$99,999. Mutual funds are even an important vehicle for those households with more modest incomes, with 37 percent of all households with income between \$25,000 and \$34,999 owning mutual funds.

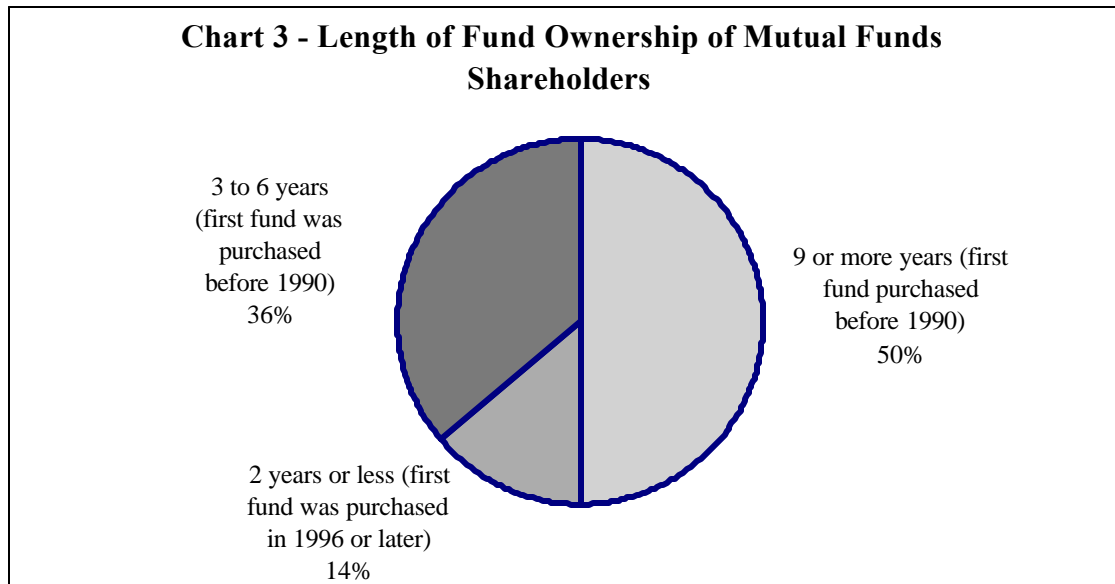
<b>Table 4 - Percent of U.S. Households Owning Mutual Funds by Household Income, 1998 - 2000</b>			
	1998	1999	2000
Less than \$25,000	13%	15%	17%
\$25,000 to \$34,999	28%	30%	37%
\$35,000 to \$49,999	47%	49%	49%
\$50,000 to \$74,999	62%	62%	66%
\$75,000 to \$99,999	72%	78%	77%
\$100,000 or more	77%	78%	79%
Less than \$50,000 (net)	27%	29%	32%
\$50,000 or more (net)	68%	70%	72%
Source: Investment Company Institute, 2000			
Note: Income ranges based upon 1997, 1998, and 1999 pre-tax household income			

Therefore, a change in the tax treatment of mutual funds as discussed in this paper would have a beneficial impact on all owners of mutual funds, but the benefits would primarily help those making less than \$100,000 a year save for their future.

Additional data from the Investment Company Institute, and summarized in the chart below, show that half of all mutual fund shareholders entered the mutual fund market nine or more years ago.<sup>22</sup> This implies that investors of mutual funds primarily are saving for the future, not engaging in day-trading behavior or other activities with a short-term focus. In fact, 75 percent of respondents who own mutual funds outside of employer-sponsored plans indicated that their primary financial goal was to save for retirement.<sup>23</sup>

<sup>22</sup> Investment Company Institute, "1998 Profile of Mutual Fund Shareholders," Washington, DC: Summer 1999, Figure 32, page 49.

<sup>23</sup> *Ibid.*, Figure 51, page 80.



Source: Investment Company Institute. "1998 Profile of Mutual Fund Shareholders." Summer 1999.

The amount of assets held in mutual funds has increased dramatically over the past few years. Mutual fund assets increased at a 23 percent annual rate during the 1990s, growing from \$1.065 trillion in 1990 to \$6.846 trillion by the end of 1999.<sup>24</sup> From 1994 to 1999, *individually* held assets in mutual funds have almost tripled from \$1.265 trillion in 1994 to \$3.725 trillion, or an annual rate of 12.75 percent. More than half of all mutual fund assets are held by individuals.

**Table 5 - Individual and Institutional Markets For All Mutual Funds**

Assets (in billions)	1994	1995	1996	1997*	1998*	1999
Individual	\$1,265 58.5%	\$1,602 56.8%	\$1,955 55.4%	\$2,500 56.0%	\$3,057 55.3%	\$3,725 54.4%
Institutional	\$897 41.5%	\$1,219 43.2%	\$1,571 44.6%	\$1,968 44.0%	\$2,468 44.7%	\$3,121 45.6%

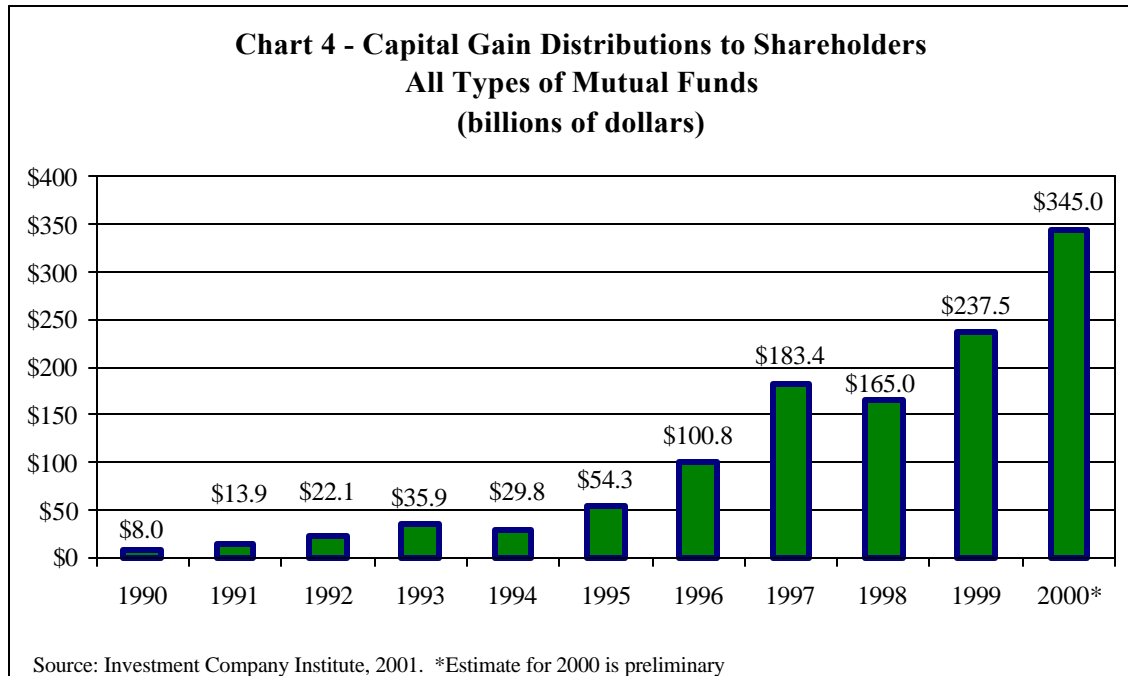
Source: Investment Company Institute, 1999

\* Revised

Institutional assets invested in mutual funds in 1999 amounted to \$3.1 trillion, representing 45.6% of all mutual fund assets. The remaining 54.4% of mutual fund assets represent investments of individuals. Institutions include fiduciaries (banks and individuals serving as trustees, guardians, and administrators), business organizations (including corporations, retirement plans, insurance companies, and other financial institutions), nonprofit organizations, and other institutional investors.

<sup>24</sup> Investment Company Institute, *Perspective*, vol. 6, no. 3, July 2000.

As the assets of mutual funds have increased, so has the amount of capital gain distributions that have been distributed to shareholders -- from a 1990 low of \$8.017 billion to a 2000 high of \$345 billion. In this time period, capital gain distributions by mutual funds have increased a sharp 4,203 percent, or an annual rate of 45.7 percent. From 1996 (when the capital gain distributions were \$100.8 billion) to 2000, the increase was 242 percent, or an annual rate of 36 percent.



This dramatic increase in the dollar amount of forced capital gain distributions has caused the average American family to be hit with a sizeable tax liability, even if they did not sell shares in their mutual fund. According to calculations by the Congressional Budget Office (CBO) based on Investment Company Institute data tabulations, traditionally-held individual mutual fund accounts (not including IRAs or pensions which defer taxation) distributed \$50.81 billion in capital gains in 1997.<sup>25</sup> This amounts to 27.7 percent of the \$183.4 billion in total capital gain distributions by mutual funds.

The CBO estimates correlate with data from the Internal Revenue Service, Statistics of Income Division (SOI). For 1997, SOI reported that \$45.1 billion of capital gain distributions were claimed on tax returns, or 24.6 percent of the total \$183.3 billion distributed.<sup>26</sup> For 1998, SOI reported that \$46.2 billion of capital gain distributions were

<sup>25</sup> U.S. Congressional Budget Office, "CBO Memorandum: The Contributions of Mutual Funds to Taxable Capital Gains," Washington, DC: October 1999.

<sup>26</sup> Internal Revenue Service, *Statistics of Income Bulletin*, Washington, DC: Fall 1999.

reported on individual tax returns, or 28.0 percent of the \$165.0 billion distributed.<sup>27</sup> This represents 16.1 million tax returns, or approximately 25 million shareholders, that could benefit from a change in the tax treatment of mutual fund capital gain distributions.

## V. POLICY ALTERNATIVES

To increase the incentives for the average American to save and invest for the future, it is recommended that the realization point that triggers a capital gains tax liability be changed from the corporate level (for companies such as mutual funds) down *exclusively* to the shareholder level. This would create a more equal tax treatment between investments in mutual funds and investments in direct stock ownership.

The Internal Revenue Code already provides a definition of a “publicly offered regulated investment company.” Specifically, section 67(c)(2)(B) defines a “publicly offered” fund as one the shares of which are (a) continuously offered pursuant to a public offering, (b) regularly traded on an established securities market, or (c) held by or for no fewer than 500 persons at all times during the taxable year.

A deferral of capital gain distributions would apply only to distributions made by regulated investment companies (e.g., mutual funds) and only for those funds that made distributions that a taxpayer elected to defer. The amount of deferral would not be allowed to exceed the capital gain distribution for each individual in each particular fund. This treatment would prevent savvy taxpayers from gaming the system.

The deferral would not apply or allowed to be offset against regular capital gains. Additionally, although a tax deferral of capital gain distributions would be taxed eventually by the government when shareholders sell their shares -- the Treasury might realize an increase in tax revenue through the compounding effect of deferral.<sup>28</sup>

A bill (H.R. 168) introduced by Rep. Jim Saxton (R-NJ) addresses the problems taxable mutual fund investors face as outlined in this study. The bill would allow a deferral of capital gain distributions up to \$6,000 for married couples filing jointly and \$3,000 for all other tax filers. The exclusion amounts would be indexed for inflation and the effective date of the legislation would be retroactive to January 1, 2000. Mutual fund companies would still make distributions, as required under current law. However, shareholders would have the ability to notify their mutual fund companies as to whether they elect to have their reinvested capital gain distributions deferred from taxation and given a zero basis in the fund.

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<sup>27</sup> Internal Revenue Service, *Statistics of Income Bulletin*, Washington, DC: Fall 2000.

<sup>28</sup> For a discussion and mathematical proof that shows how deferral of taxation would eventually increase tax revenue to the government, see Irving Fisher, “Paradoxes in Taxing Savings,” *Econometrica*, vol. 10, issue 2, April 1942.

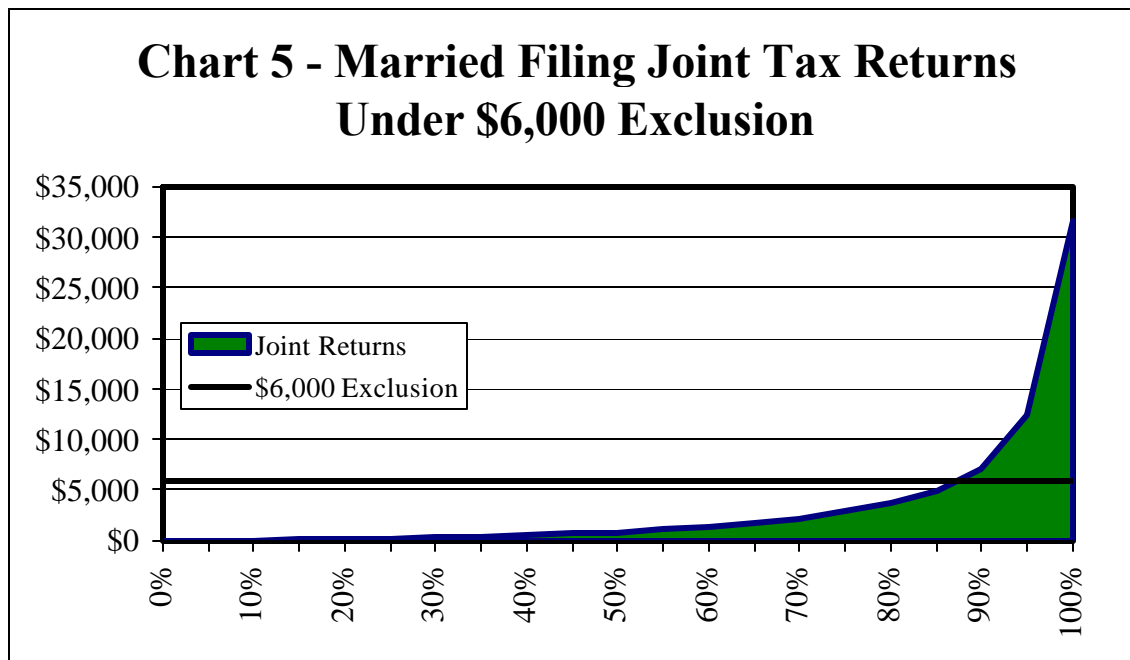
The deferral provision in Rep. Saxton's bill would provide substantial benefits to low- and middle-income taxpayers that invest in mutual funds. As highlighted in Table 6, for a hypothetical taxpayer with an initial \$10,000 investment in a mutual fund that returns 10 percent a year, the deferral on capital gain distributions would amount to \$15,055 over a 30-year period. This represents almost a 15 percent greater *after-tax* return than would be achieved under the current law which unfairly taxes mutual fund capital gain distributions. The \$15,055 increase in *after-tax* return that would arise under the deferral provision of Rep. Saxton's bill is equivalent to approximately 150 percent of the original \$10,000 investment. The benefits of capital gain distribution deferral would significantly aid American families saving for their future.

Table 6 - Benefit of Deferral to the Mutual Fund Investor						
\$10,000 Initial Investment						
Time Horizon	5 - Years	10 - Years	15 - Years	20 - Years	25 - Years	30 - Years
Pre-Liquidation Value With Deferral on Capital Gain Distributions	\$15,499	\$24,023	\$37,235	\$57,713	\$89,452	\$138,646
After-Tax Redemption Value	\$14,659	\$21,880	\$33,073	\$50,420	\$77,308	\$118,984
Pre-Liquidation Value Without Deferral on Capital Gain Distributions	\$14,940	\$22,320	\$33,345	\$49,817	\$74,426	\$111,191
After-Tax Redemption Value	\$14,585	\$21,436	\$31,670	\$46,960	\$69,802	\$103,929
After-Tax Difference (\$)	\$74	\$445	\$1,403	\$3,461	\$7,506	\$15,055
After-Tax Difference (%)	0.5%	2.1%	4.4%	7.4%	10.8%	14.5%
Note: Hypothetical Example - Assumes (1) an annual 10% rate of return; (2) of which dividends account for 30% of return and capital gains distributions account for 40% of return (3) distributions are reinvested net of taxes due. Hypothetical example is similar to that used by KPMG 2000 & do not account for state taxes.						

The current provisions under Rep. Saxton's bill that would allow for an annual deferral of \$6,000 for married couples filing jointly and \$3,000 for all other tax filers would cover the vast majority of taxpayers. Based on estimates by the Joint Economic Committee using public data available from the IRS, Chart 5 shows that approximately 85 percent of all married taxpayers who file tax returns jointly and claim capital gain distributions have net capital gain distributions that are under the exclusion amount (\$6,000) for their filing status and would receive the full benefits of deferral under Rep. Saxton's bill.<sup>29</sup>

<sup>29</sup> Charts five and six are based on JEC estimates using extrapolated data from the Internal Revenue Service, Statistics of Income Division 1995 and 1996 Public Use Files. Due to the skewed nature of income data, the point estimate at the 100 percent level represents an average of the top 5 percent.

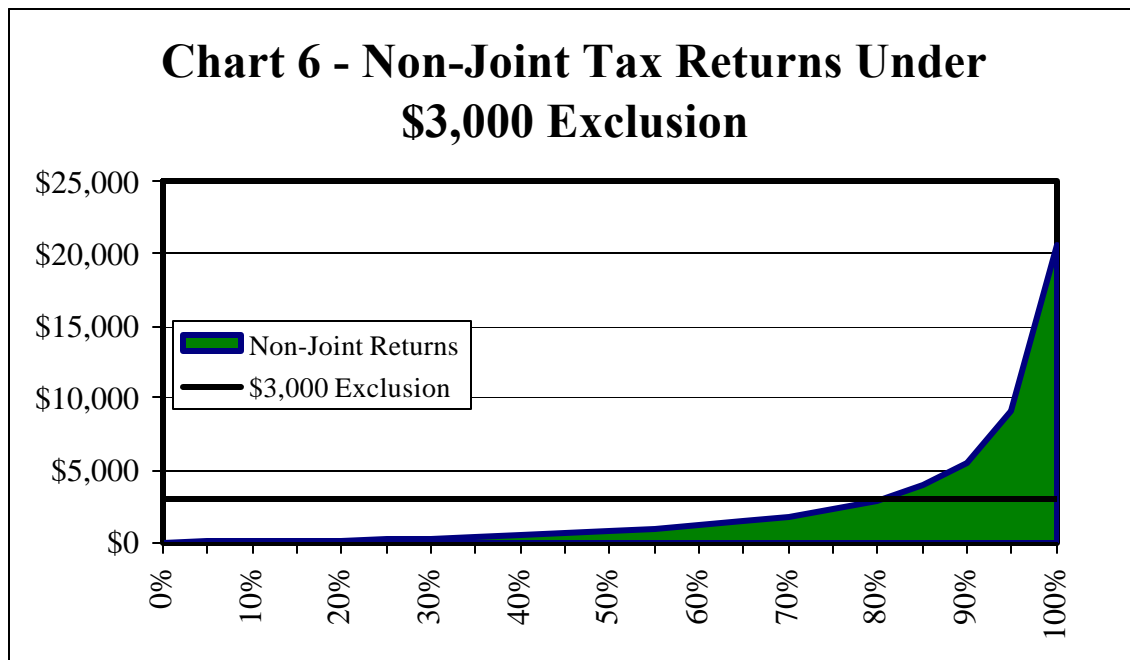
**Chart 5 - Married Filing Joint Tax Returns  
Under \$6,000 Exclusion**



Note: For scaling purposes, the data point representing the 100<sup>th</sup> percent level is an average of the top five percent of returns. Some taxpayers reported over several million dollars of capital gain distributions.

Chart 6 shows that for all other filing statuses that claimed capital gain distributions, approximately 80 percent are estimated to be under the exclusion amount (\$3,000). These taxpayers would be able to elect a full deferral of their capital gain distributions.

**Chart 6 - Non-Joint Tax Returns Under  
\$3,000 Exclusion**



Note: For scaling purposes, the data point representing the 100<sup>th</sup> percent level is an average of the top five percent of returns. Some taxpayers reported over several million dollars of capital gain distributions.

The remaining taxpayers with capital gain distributions greater than the deferral ceiling would still be allowed to defer up to \$3,000 or \$6,000 of capital gain distributions, depending on filing status. However, they would have to adjust their cost basis in the funds for which the capital gain distributions exceeded the deferral ceiling amount.

The Appendix to this paper provides the author's examples of what IRS forms might look like for reporting deferral of capital gain distributions. Example distributions are also provided to illustrate the simplicity of this process. Additionally, since many funds keep track of distributions and calculate average cost basis for shareholders, a sample reinvestment form is also provided in the Appendix. This would allow mutual funds a simple way to continue the service they provide to many shareholders of tracking and calculating average cost basis.

## VI. CONCLUSION

Tax policies are often evaluated based on three criteria: efficiency, equity and simplicity. An efficient tax policy is one that raises the most amount of revenue while causing the least economic distortion. Equity implies that people with similar incomes and circumstances should pay the same. Tax simplicity suggests that tax policy be simple to understand and comply with, or reduce the complexity of an existing tax policy.

This study proposes that the tax treatment of unrealized capital gains be changed so that the point of realization that triggers a capital gains tax liability is moved from the corporate level exclusively to the individual level. This would increase the efficiency, equity and simplicity of the tax system.

In the long run, allowing for a deferral of capital gain distributions will improve economic efficiency by increasing the returns shareholders receive on their investment. Additionally, in the long run, an increase in investor returns would likely result in an increase in tax revenue to the government.<sup>30</sup> Hence, both individual investors and the U.S. Treasury would benefit from this tax change. Lastly, this proposed tax change would move toward more equal tax treatment between investments in mutual funds and investments in direct stock ownership.

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<sup>30</sup> For a discussion and mathematical proof that shows how deferral of taxation would eventually increase tax revenue to the government, see Irving Fisher, "Paradoxes in Taxing Savings," *Econometrica*, vol. 10, issue 2, April 1942.

Mutual funds have increasingly become an important vehicle for low- and middle-income households to invest in the stock market and save for the future. Changing the realization point of capital gain taxation from the corporate level exclusively to the individual level is equitable and fair since shareholders of mutual funds are primarily affected by the current tax treatment of unrealized capital gains.

Although a change in the tax treatment of mutual funds would have a beneficial impact on all owners of mutual funds, the benefits would primarily accrue to those making less than \$100,000 a year, low- and middle-income investors; with 39 percent of households owning mutual funds earning less than \$50,000 a year.<sup>31</sup>

The forced distribution of a capital gains tax liability by regulated investment companies, such as mutual funds, to individual shareholders increases the complexity taxpayers must confront when filing their yearly income tax returns. Changing the realization point of capital gains taxation may make it easier for taxpayers to figure out their cost basis when they redeem their shares for cash. This change may also help to reduce the instances where taxpayers pay more in tax than necessary because of failure to adjust their cost basis for reinvested capital gains.

This treatment is basically a type of capital gains rollover. The deferral of capital gain distributions would distinguish between sales of assets to finance consumption and sales in which the proceeds are reinvested to increase saving and investment. Furthermore, a deferral of capital gain distributions “is a natural extension of the realization principle of taxation: that is, tax is due only when the owner of an asset has exchanged it for cash.”<sup>32</sup>

The current tax treatment of taxing reinvested mutual fund capital gain distributions results in significant lost return for millions of mutual fund investors. For a hypothetical taxpayer with an initial \$10,000 investment in a mutual fund that returns 10 percent a year, the deferral on capital gain distributions would amount to \$15,617 over a 30-year period *after taxes*. This represents almost a 15 percent greater *after-tax return* than would be achieved under current law, which unfairly taxes mutual fund capital gain distributions. The \$15,055 increase in *after-tax return* that would arise under the deferral provision of Rep. Saxton’s bill (H.R. 168) is equivalent to approximately 150 percent of the original \$10,000 investment.

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<sup>31</sup> Investment Company Institute and the Securities Industry Association, “Equity Ownership in America,” Washington, DC: Fall 1999, page 43.

<sup>32</sup> Leonard Burman, *The Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed*. Washington, DC: The Brookings Institution, 1999, page 136.



According to the Investment Company Institute, the median value of stock mutual funds held outside of employer-sponsored retirement plans in 1999 was \$26,000.<sup>33</sup> Assuming the same 10 percent rate of return, the deferral proposed under Rep. Saxton's bill could increase the *after-tax return* to the median shareholder by \$8,998 over 20 years and \$39,143 over 30 years! The benefits of capital gain distribution deferral would significantly aid American families saving for their future.

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Senior Economist

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<sup>33</sup> Investment Company Institute and the Securities Industry Association, "Equity Ownership in America," Washington, DC: Fall 1999, page 43.

## **APPENDIX – DETAILS OF THE DEFERRAL MECHANISM UNDER H.R. 168 AND SAMPLE TAX SCHEDULES**

H.R. 168, introduced by Rep. Jim Saxton (R-NJ), addresses the problems taxable mutual fund investors face as outlined in this study. The bill would allow a deferral of capital gain distributions up to \$6,000 for married taxpayers filing a tax return jointly and \$3,000 for all other filers. Mutual fund companies would still make distributions, as required under current law. However, under H.R. 168, these reinvested capital gain distributions would be deferred from taxation and given a zero basis by the fund.

Based on estimates by the Joint Economic Committee using public data available from the IRS, between 80 percent and 85 percent of all taxpayers who claim capital gain distributions on their tax returns have net capital gain distributions that are under the exclusion amount for their filing status.<sup>34</sup> These taxpayers would be able to elect a full deferral of their capital gain distributions. This treatment greatly simplifies the taxation of capital gain distributions and would not require most taxpayers to file additional schedules.

The minority of remaining taxpayers would still be allowed to defer up to \$3,000 or \$6,000 of capital gain distributions, depending on filing status, and would have to adjust their cost basis in the funds for which the capital gain distributions exceeded the deferral ceiling. If for any reason taxpayers determined that they didn't want the benefits of deferral, they could continue to reinvest capital gain distributions, with basis, as is the practice under current law. Taxpayers would simply inform their mutual funds whether deferral of capital gain distributions were chosen, to properly account for basis.

Following are potential alternatives of what tax schedules might look like for reporting deferral of capital gain distributions. Example distributions are also provided to illustrate the simplicity of this process. Additionally, since many funds keep track of distributions and calculate average cost basis for shareholders, a sample reinvestment form is also provided. This would allow mutual funds a convenient way to continue the service they provide to their shareholders of tracking and calculating average cost basis.

The following alternatives outline two simple ways that the deferral can be elected and the average cost basis calculated, if necessary, for those taxpayers who have capital gain distribution in excess of the deferral ceiling amount.

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<sup>34</sup> Estimates based on JEC estimates using extrapolated data from the Internal Revenue Service, Statistics of Income Division 1995 and 1996 Public Use Files.

The alternatives display what a new IRS schedule (Schedule CGD) might look like that would walk taxpayers through the process of reporting and claiming a deferral on capital gain distributions made by mutual funds.

### Alternative 1

[illegible]

Non-allowable (excess) capital gain distribution amounts listed in Column 1(d) would have to be added to the cost basis of the corresponding mutual funds. This excess amount would be treated just like a normal purchase of fund shares with the dollar value being treated just as a reinvested capital gain distribution is treated now. This would allow the mutual funds and/or shareholders to continue to calculate and use average cost basis for fund shares.

Since many mutual fund companies now perform this service for their shareholders, a reinvestment form could be submitted by the shareholder to the fund. This reinvestment form would serve just like a deposit slip to purchase more shares in the fund. A sample reinvestment form is provided at the end of the Appendix.

For taxpayers who have total capital gain distributions less than the deferral ceiling it is even easier. These taxpayers would not have to fill out Schedule CGD, unless they chose to do so for their own record-keeping purposes. Under current law, taxpayers who only have capital gain distributions from mutual funds (and no other capital gains) are allowed to report the net amount of capital gain distributions directly on Line 13 of Form 1040 or Line 10 of Form 1040A without having to fill out a Schedule D.

Under Rep. Saxton's bill (H.R. 168), a taxpayer who has total mutual fund capital gain distributions under the deferral ceiling amount corresponding to that taxpayer's filing status would not have to report any distribution amounts on Line 13 of Form 1040 or Line 10 of Form 1040A, or could just report a zero amount. However, taxpayers who want to keep a more accurate record of their distributions or organize all of their information in one place could still fill out a Schedule CGD.

For taxpayers with total capital gain distributions above the deferral ceiling, the first method of calculating how much distribution of each fund to defer is decided by the taxpayer, limited to the amount each fund distributed. A different approach would be to pro-rate the allowable amount, as illustrated below in Alternative 2.

## Alternative 2

[illegible]

Again, using this second approach to account for excess capital gain distributions, the process outlined in the Schedule is relatively simple and would not add much complexity to the preparation of tax returns. For taxpayers with excess capital gain distributions above the deferral ceiling, they still get benefits of deferral.

For the 80 percent to 85 percent of tax returns that are estimated by the Joint Economic Committee to be completely covered by the deferral ceilings, tax preparation would be less complex than it is today and taxpayers get the full benefits of tax deferral. Taxpayers with excess capital gain distributions above the deferral ceiling still get benefits of some deferral and the necessary adjustments to cost basis do not add an unnecessary burden of additional tax complexity.

Since some shareholders might choose not to elect deferral of their mutual fund capital gain distributions, shareholders would have the option to notify their mutual fund companies as to whether they want to have their reinvested capital gain distributions deferred from taxation and given a zero basis in the fund. Though this study has shown that the benefits of tax deferral more than outweigh any additional tax complexity that might be created by filling out an additional schedule, if for any reason taxpayers determined that they didn't want the benefits of deferral, they could continue to reinvest capital gain distributions, with basis, as is the practice under current law.

As discussed briefly earlier, many mutual fund companies now perform a service for their shareholders of keeping track of fund distributions and adjusted share basis. Using a very simple reinvestment form, mutual fund companies could continue to perform this service for their shareholders. This reinvestment form would serve just like a deposit slip to purchase more shares in the fund. A sample reinvestment form is provided below.

MUTUAL FUND COMPANY NAME		2000
<b><u>Non-Allowable Mutual Fund Capital Gain Distributions Reinvestment Form</u></b>		
Name(s) of account owner(s)		Social Security Number
		000-00-0000
<b>Fund Name(s)</b>	<b>Capital Gain Distributions Reported to you on Box 2 (a) of Form 1099-DIV</b>	<b>Non-Allowable Deferral from Line 1 (d) of Schedule CGD</b>
Fund XYZ	\$1,000.00	\$1,000.00
<b>Total</b>	<b>\$1,000.00</b>	<b>\$1,000.00</b>
Signature(s) of Account Owner(s)		
Primary Account Owner		Joint Account Owner
Date		Date

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